Examiner Guidelines Used in Performing Year 2000 Examinations

PURPOSE

The purpose of this document is to detail the criteria that examiners will use to evaluate the overall effectiveness of an institution's year 2000 program. The OCC will apply these criteria to national banks and the independent data centers it supervises. Examiners will make a summary evaluation, using the three-tiered structure outlined below, after **every** onsite year 2000 examination performed using the examination procedures contained in the May 5, 1997, FFIEC Interagency Statement. The summary evaluation should be updated based on supervisory activities performed subsequent to the examination.

OVERVIEW

The year 2000 affects all institutions, regardless of size, complexity, or geography. Institutions should have completed project plans to correct programming deficiencies related to the year 2000. These plans must recognize the risk facing banks and their data processing servicers.

Institutions that develop their own core (mission-critical) applications face a different set of year 2000 challenges than those that rely on third-party providers of data processing products or services (vendors). Year 2000 project plans should be tailored to the complexity of each institution's operational processes, the expertise of its staff, and the nature of its dealings with external entities. Examiners should understand the impact of the year 2000 on the institutions they supervise as well as the effectiveness of the institutions' effort to manage these risks.

Despite differences in banks' risk profiles, every year 2000 project plan should address certain issues. Each plan must be thorough and account for all systems that are anticipated to pose problems--not only core data processing systems, but also environmental systems, such as elevators, vaults, and other systems that are controlled by imbedded microchips. The institution's plans must provide sufficient time to test converted systems and their interconnections with other systems, whether these are developed in house or are outsourced.

If an institution depends on third-party suppliers of data processing products and services, the project plan should include due diligence that allows the institution to monitor the conversion efforts of these suppliers. This due diligence process should, at a minimum, include:

1. An analysis of the supplier's ability to support a year 2000 corrective program;
2. A review of contract provisions;
3. Contingency plans, with specific trigger dates, in the event a vendor is unable to deliver products or services that are year 2000 ready;
4. Ongoing dialogue with vendors, including a review of the vendor's year 2000 remediation progress; and

5. Development of a program to test each vendor's renovated products or services within the institution's unique operating environment.

All financial institutions also should ensure that they manage the indirect risk posed to bank clients, whether fund takers (e.g., borrowers or bond issuers), fund providers, or other counterparties (e.g., capital market partners). Detailed guidelines for managing the year 2000 risk posed by bank customers are outlined in the interagency statement and other FFIEC year 2000 guidance.[1]

SUMMARY EVALUATIONS

The year 2000 poses unique challenges to the institutions we supervise. Because the problem is time sensitive, bank regulatory agencies must take decisive supervisory action when significant deficiencies are identified. Examiners should identify all year 2000 program deficiencies, discuss them with management, and ensure that they are documented consistent with the supervisory/enforcement guidelines on the year 2000[2].

In evaluating an institution's year 2000 efforts, examiners will normally assess the adequacy of its year 2000 program and the relative progress the institution has made in implementing its project plan. To meet the challenges posed by the year 2000, institutions will not only have to develop a program that encompasses the elements previously discussed, but will have to successfully implement all of the project plan's varied activities. To measure the bank's progress in managing the process, examiners should review the bank's year 2000 activities to date and appraise the bank's ability to meet internal and FFIEC deadlines.[3]

Satisfactory

---

[1] The FFIEC has issued two interagency statements on the year 2000, one in June 1996 and the other in May 1997. Guidance will be forthcoming outlining regulatory expectations for management and the board, vendor management, the year 2000 impact on large bank customers, and testing. Additional year 2000 guidance will be issued, as necessary, in 1998 and 1999.

[2] Soon after the distribution of these instructions a document will be issued outlining the supervisory and enforcement approach the OCC will take in identifying, documenting, and monitoring year 2000 corrective efforts. Supervisory offices must ensure that as examinations and quarterly updates are completed, the year 2000 issues, concerns, and deficiencies are handled in a manner consistent with these guidelines.

[3] The May 5, 1997 Interagency Statement establishes three project management benchmarks. By September 30, 1997, institutions should have completed the assessment phase and have developed a project plan that address all year 2000 issues. By December 31, 1998, renovation of existing applications should be complete. Lastly, testing for mission-critical applications should be well under way by December 31, 1998. Other benchmarks may appear in upcoming guidance documents.

Examiner Guidelines Used in Performing Year 2000 Examinations

Year 2000 efforts of financial institutions and independent data centers are considered "Satisfactory" if they exhibit acceptable performance in all key phases of the year 2000 project management process as set forth in the May 5, 1997 FFIEC Interagency Statement on the year 2000 and subsequent guidance documents. Performance is satisfactory when project weaknesses are minor in nature and can be readily corrected within the existing project management framework. The institution's remediation progress to date meets or nearly meets expectations laid out in its year 2000 project plan. Senior management and the board recognize and understand year 2000 risk, are active in overseeing institutional corrective efforts, and have ensured that the necessary resources are available to address this risk area.

Banks – In banks that develop their own core (mission-critical) applications, comprehensive project plans and budgets have been adopted addressing significant areas of concern. Project plans include reasonable time frames with achievable objectives. In banks using suppliers of data processing products and services, an effective due diligence process manages these key relationships. The due diligence process addresses each of the five elements outlined above. Bank investment and lending practices reflect the credit impact that the year 2000 may have on large borrowers or bond issuers, including those outlined in the Interagency Statement or subsequent FFIEC guidance.

Independent Data Centers – The program of a data center evaluated as "Satisfactory" should have the strengths identified above. A satisfactory evaluation is appropriate if the data center also is actively communicating with client banks and makes its year 2000 project objectives and benchmarks available to them.

Needs Improvement

Year 2000 efforts of financial institution and independent data centers are evaluated as "Needs Improvement" if they exhibit less than satisfactory performance in any of the key phases of the year 2000 project management processes outlined below. Project weaknesses are evident, even if deficiencies are correctable within the existing project management framework. The institution's remediation progress to date is behind the schedule laid out in its year 2000 project plan. Senior management or the board is not fully aware of the status of year 2000 corrective efforts, may not have committed sufficient financial or human resources to address this risk, or may not fully understand year 2000 implications.

Banks – In banks that develop their own core (mission-critical) applications, project plans and budgets may have been adopted but may be lacking in significant areas or are informal. Project plans may not provide sufficient scheduling flexibility to ensure remediation of all affected mission critical systems and applications, should unexpected problems be encountered. In banks using third-party suppliers of data processing products and services, a due diligence process though in place, lacks one or more of the key elements outlined above. Bank investment and lending practices address the credit implications the year 2000 may have on large borrowers or bond issuers but do not include all process elements outlined in the interagency statement or subsequent FFIEC guidance.

Independent Data Centers – Program weaknesses identified above should be reflected in a data center evaluated as "Needs Improvement." This evaluation may also be appropriate if vendor communication with client banks is sporadic or if project objectives and benchmarks are difficult to obtain.

Unsatisfactory

Year 2000 efforts of financial institutions and data centers are "Unsatisfactory" if they exhibit poor performance in any of the key phases of the year 2000 project management process outlined below. Project weaknesses are serious in nature and are not easily corrected within the existing project management framework. The institution's remediation progress to date is seriously behind the schedule laid out in its year 2000 project plan. Senior management and the board do not understand or recognize the impact that the year 2000 will have on the institution. Management or the board commitment is limited or their oversight activities are not evident.

Banks – In banks that develop their own core (mission-critical) applications, project plans and budgets have not been adopted or are seriously inadequate. Project plans lack time frames or the plans adopted are unrealistic or will not remediate mission-critical applications/systems within the FFIEC deadlines. In banks using third-party suppliers of data processing products and services, no due diligence process is in place, or is flawed due to a lack of several key elements. Bank investment and lending practices do not address the credit impact the year 2000 may have on large borrowers or bond issuers, or they lack several of the process elements outlined in the Interagency Statement or subsequent FFIEC guidance.

Independent Data Centers – When a data center exhibits program weaknesses identified above, it should be evaluated as "Unsatisfactory." This evaluation may also be appropriate if a data centers' communication with client banks is unclear and inaccurate, or if project objectives and benchmarks are not available.

EICs should notify Bank technology, as well as their respective technology/BIS lead expert or the director for BIS Examination Support (for large banks and MDPS centers) whenever a bank is evaluated as "Needs Improvement" or "Unsatisfactory."

Examiner Guidelines Used in Performing Year 2000 Examinations

IMPACT ON CAMELS RATINGS

The year 2000 poses significant risks to an institution, potentially touching all aspects of the organization. The institution's ability to manage these risks should be appropriately reflected in the BIS and CAMELS ratings. The OCC will use the year 2000 Summary Evaluation as the primary tool to reflect year 2000 risk in an institution's supervisory ratings. While the following guidelines are directed at EICs, rating changes due to year 2000 findings will need to go through the existing review procedures of each supervisory office.

A "Satisfactory" evaluation need not affect any of the CAMELS or BIS ratings, because the OCC believes that adoption of a sufficiently comprehensive year 2000 program is a minimum requirement for every management team. Failure to institute a satisfactory year 2000 program however, is indicative of poor management practices, that could compromise both the operational and financial functions of the institution.

To a bank that "Needs Improvement**,**" the EIC should assign a BIS management rating of 3, and should consider assigning it a 3 for the M in CAMELS. The BIS composite and other component ratings (Audit, Operations and Systems & Programming) should reflect the deficiencies identified. EICs have flexibility in determining composite and component ratings, if they believe the bank has the ability to correct problems in a timely manner and if management has adequately demonstrated that corrective action will be aggressively pursued. If management subsequently demonstrates an inability to address noted deficiencies, rating downgrades should be initiated.

Any institution with a year 2000 project program that is "Unsatisfactory." should receive no better than a 3 rating for both BIS and CAMELS management components. Other CAMELS and BIS component ratings should be adjusted as necessary, to reflect all identified program deficiencies. Adjustments to ratings are warranted when problems are so great that they raise questions regarding the institution's ability to successfully complete its year 2000 program. Consideration also should be given to downgrading the institution's composite CAMELS rating, if that rating is 1. Similarly, the EIC should give consideration to downgrading the composite BIS rating, if that rating is 2 or better. EICs may delay downgrading a rating as long as (1) management is aggressively pursuing effective corrective action that addresses all identified concerns, (2) the EIC remains confident that the institution will have begun testing of mission critical systems by year-end 1998, and (3) these systems will be ready for the year 2000 on time.

IMPACT ON RISK ASSESSMENT SYSTEM

The year 2000 Summary Evaluation should also be used in evaluating the quality of risk management, aggregate risk, and direction of risk as defined in the OCC's Risk Assessment System (RAS). For the purposes of RAS, year 2000 supervisory activities will primarily affect transaction and strategic risks. However, examiners should consider the impact on other risk categories, as appropriate.

Examiner Guidelines Used in Performing Year 2000 Examinations

A "Satisfactory" evaluation should not affect RAS evaluation factors or risk assessments.

For large and mid-sized banks that are evaluated as "Needs Improvement," the EIC should consider a quality of risk management assessment of "weak." For all banks, a "Needs Improvement" evaluation may increase the aggregate risk exposure as it increases the bank's potential risk for financial loss and may adversely impact operating controls. While a "Needs Improvement" evaluation adds to the aggregate transaction and strategic risk; adjustment to the current assessment should be made based on a complete review of transaction or strategic risk factors. A change in the direction of transaction and strategic risks should also be considered, particularly for institutions with a current assessment of "decreasing." Other RAS risk category assessments should appropriately reflect the deficiencies identified.

When large and mid-sized banks are evaluated as "Unsatisfactory," a "weak" quality of risk management assessment should be assigned. For banks of any size that are evaluated as "Unsatisfactory," the aggregate transaction risk assessment should be adjusted to "high," and consideration given to adjusting the aggregate strategic risk assessment to "high." The direction of transaction and strategic risks should be designated "increasing." Other RAS risk categories should appropriately reflect the deficiencies identified.

EICs may delay assessment downgrades as long as (1) management is aggressively pursuing effective corrective action that addresses all identified concerns, (2) the EIC remains confident that the institution will have begun testing of mission critical systems by year-end 1998, and (3) these systems will be ready for the year 2000 on time.